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January 9, 2003

Marlene H. Dortch
Secretary
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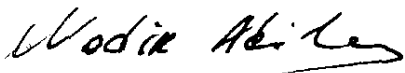
Re: Implementation of Section 11 of the Cable Television Consumer Protection and Competition Act of 1992, CS Docket No. 98-82; Implementation of Cable Act Reform Provisions of the Telecommunications Act of 1996, CS Docket No. 96-85; The Commission's Horizontal and Vertical Ownership and Attribution Rules, MM Docket No. 92-264; Review of the Commission's Regulations Governing Attribution of Broadcast and Cable/MDS Interests, MM Docket No. 94-150; Review of the Commission's Regulations and Policies Affecting Investment in the Broadcast Industry, MM Docket No. 92-51; Reexamination of the Commission's Cross-Interest Policy, MM Docket No. 87-154

Dear Ms. Dortch:

Pursuant to Section 1.1206 of the Commission's rules, attached for inclusion in the record in the above-referenced proceeding is an article I authored, dated December 11, 2002, entitled "Pivotal Buyers and Bargaining Power: A Non-Linear Least Squares Estimate from the Cable Industry"

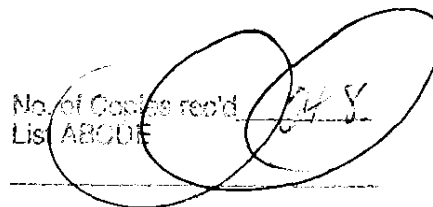
Please do not hesitate to contact me with any questions.

Sincerely



Nodir Adilov

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Pivotal Buyers and Bargaining Power: A Noli-Linear. Least Squares Estimate from the Cable Industry

Nodir Adilov

December 11, 2002

ABSTRACT

Raskovich (2001) suggests becoming pivotal through merger worsens the merging buyer's bargaining position. Adilov and Alexander (2002) show these results hold only in the case where buyer bargaining power is constant. In this paper, I estimate bargaining power by nonlinear least squares using data from an experimental cable study conducted by Bykowski, Kwasnica, and Sharkey (2002), and reject the hypothesis that bargaining power is constant across buyers even when channel capacity constraints and 'most-favored-nation' clauses are absent. (JEL L40, L41, L96, L25)

I Introduction

Economic theory does not give a definitive answer on how a surplus should, or would, be divided among parties to an exchange. In fact, different assumptions regarding the division of the surplus from trade yield significantly different

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theoretical conclusions. Such is the case in the cable industry.

Chitty and Snyder (1999) demonstrate that when the bargaining surplus is divided equally among parties, the change in bargaining position for a merged firm is solely determined by the shape of the value function. They estimate the value function to be convex for the entire cable industry; hence, merger worsens the merged firm's bargaining position. Chitty and Snyder argue that observed lower per customer transfer prices from larger buyers are due to cost efficiencies and not because of greater bargaining power on the part of larger buyers.

Raskovich (2001) extends the Chitty and Snyder (1999) model to include pivotal buyers. Pivotal buyers are large buyers whose contribution is necessary in order for sellers to recover their costs. In the model, Raskovich shows that, under a 50-50 split, becoming pivotal worsens the merged firm's bargaining position. The intuition behind this result can be explained by the solution to the "streetlight" public good provision problem: smaller buyers free ride on larger buyers' contributions.

Adilov and Alexander (2002) generalize Raskovich's (2001) model to allow for any split of the surplus among parties. Adilov and Alexander show that Raskovich's pivotal buyer result only holds as long as the split is constant for all firms. However, when bargaining power differs across firms, Adilov and Alexander show that the use of the value function for evaluating merger effects can be misleading, and that pivotal firms can improve their bargaining position, sometimes at the expense of other smaller (pivotal) buyers. Clearly, whether bargaining power is constant across buyers is an important empirical question.

Bykowski et al. (2002) conducted experimental studies of the cable industry

to evaluate the effects of merger. They concluded that only under MFN status or channel capacity constraints will larger firms systematically gain greater benefit from trade. The purpose of this paper is to determine whether bargaining power is the same across firms under the pivotal mechanism - in the absence of channel capacity limitations and MFN provisions - using the Bykowski et.al. experimental data.

The paper is organized as follows. First, I present a theoretical model of transfer price determination with asymmetric bargaining power and pivotal buyers. Next, I discuss the Bykowski et al. (2002) data and the econometric techniques used to estimate bargaining power. In the penultimate section, I present and discuss the results of estimation. Finally, I make some concluding remarks.

II Equilibrium Transfer Prices with Pivotal Buyers

In this section, following the model of Adilov and Alexander (2002), I define the transfer prices faced by pivotal and non-pivotal buyers, and define the equilibrium under a pivotal mechanism with variable bargaining power among buyers.

I assume that there are I buyers and K sellers. Sellers are independent in the sense that transactions with one seller do not affect any buyer's behavior with respect to any other seller. This is a standard assumption for all of the models discussed in the previous section. I assume that the i^{th} buyer's surplus is given by $v_i = (q_i, q_{-i})$, while the supplier's gross surplus equals $V(Q)$, where $Q = \sum_{i=1}^I q_i$ is the total quantity purchased from the supplier. Specifically, $V(Q) = A(Q) - C(Q)$, where $A(Q) \equiv$ ancillary revenue, and $C(Q) \equiv$ total cost.

For the cable industry $A(Q)$ represents advertising revenue and $C(Q)$ represents the cost of programming, which is usually fixed. The supplier will produce **iff.**

$$V(Q) - \sum_{i=1}^I T_i \geq 0 \quad (1)$$

Let:

$$q_i^* = \arg \max_x [v_i(x, q_{-i}) + V(Q_{-i} + x)] \quad (2)$$

where I assume there exists a q_i^* that maximizes joint surplus (the surplus from trade has to be positive at the optimal quantity for any buyer, i.e. $v_i + V - V_{-i} > 0$ for all i). Buyer i is pivotal if the seller cannot cover its costs without buyer i , and therefore has to conclude an agreement with buyer i in order to produce. Formally, buyer i is pivotal iff:

$$V(Q_{-i}) - \sum_{j \neq i} T_j < 0 \quad (3)$$

and

$$\max_x [v_i(x, q_{-i}) + V(Q_{-i} + x)] + \sum_{j \neq i} T_j \geq 0 \quad (4)$$

where $v_i(0, q_{-i}) = 0$. V_{-i} may vary across buyers

Based on the pivotal mechanism, the transfer price for a noli-pisotat buyer is given by $T_i = (v_i + (V - V_{-i}))(1 - \alpha_i) - (V - V_{-i})$ which can be written as:

$$T_i = v_i(1 - \alpha_i) - \alpha_i(V - V_{-i}) \quad (5)$$

The transfer price for a pivotal buyer (noting that for a pivotal buyer $\sum_{j \neq i} T_j - V_{-i} < 0$) can be written as $T_i = [v_i + (\sum_{j \neq i} T_j - V)](1 - \alpha_i) - V - \sum_{j \neq i} T_j$, or as:

$$T_i = v_i(1 - \alpha_i) - \alpha_i(\sum_{j \neq i} T_j + V) \quad (6)$$

Definition 1: Define the equilibrium in quantities to be purchased $(q_1^*, q_2^*, \dots, q_n^*)$ and transfer prices (T_1, \dots, T_n) such that the following hold simultaneously for all i :

$$q_i^* = \arg \max_x (v_i(x, q_{-i}^*) - V(\sum_{j \neq i} q_j^* + x)) \quad (7)$$

$$T_i = v_i(x, q_{-i}^*)(1 - \alpha_i) - \alpha_i(V(Q^*) - V(Q^* - q_i^*)) \quad (8)$$

$$\text{if } \sum_{j \neq i} T_j - V(Q^* - q_i^*) \geq 0$$

$$T_i = v_i(x, q_{-i}^*)(1 - \alpha_i) - \alpha_i(\sum_{j \neq i} T_j - V(Q^*)) \quad (9)$$

$$\text{if } \sum_{j \neq i} T_j - V(Q^* - q_i^*) < 0$$

$$\sum_{j=1 \dots n} T_j - V(Q^*) \geq 0 \quad (10)$$

Under these conditions, production is efficient and there exists an equilibrium that satisfies the conditions of Definition One. However, as shown by Raskovich (2001), the equilibrium may not be unique, even under 50-50 split. While the existence of multiple equilibria does not pose a theoretical problem, in the next section methods for avoiding estimation problems in the context of multiple equilibria will be discussed.

III Data and Estimation

A Data

Bykowsky et al. (2002) conducted an experimental study to evaluate the effects of merger under different economic settings (capacity constraints, MFN clauses, etc.). In what follows, I use data from the no capacity constraint, no MFN treatment, with five buyers and four sellers, since this setting most precisely parallels the theoretical model from the previous section.¹ Bykowsky et al refer to this case as **tlir** low concentration, no MFN, no capacity constraint treatment. In these experiments, buyers and sellers conducted eight rounds of trades. Each buyer knew its own size and valuation, but not the seller's valuation. Each seller knew its own valuation but not the buyers' valuations. The price was negotiated by submitting buy and sell orders at a specific price with a specific seller or buyer. Both sellers and buyers could change their orders until the *bid* was accepted by the negotiating party. In accordance with cable industry practices, the negotiated prices were only known to the parties directly involved in the negotiation. The data from **tlir** experiments includes the transfer prices, buyers and sellers valuations, and the fixed costs of producers. There are 153 observations, ignoring seven trades for which parties could not reach an agreement during the allotted time period.

¹Neither channel capacity constraints, nor MFN clauses give the desired level of control since buyers and sellers will directly **affect** the transfer prices, and not strictly or exclusively via the **pivotal mechanism**.

B Empirical Model of Transfer Price Determination with Pivotal Buyers

Actual transfer prices may differ from theoretically predicted transfer prices for several reasons. For the data from the Bykowsky et al. (2002) experimental study, the deviations may come from uncertainty concerning seller costs (buyer benefits), transfers from other buyers, or some random factors. Since buyers do not know seller costs and transfer prices to be paid by other buyers, they form an expectation concerning their pivotal-ness to program production. In the actual cable industry, buyers form their expectations based on previous transactions, market research, and signals from sellers and other buyers. Even if the buyer does not know the transfer prices from other buyers, the seller is forced to negotiate tougher with pivotal buyers to cover its costs. Moreover, large buyers know that they are large and therefore likely to be pivotal. Thus, the pivotal mechanism will likely affect the transfer price in some fashion. For buyer i being pivotal for seller k requires:

$$V_k(Q_{-i}) + \sum_{j \neq i} T_{k,j} < 0 \Leftrightarrow V_k(Q) - V_k(Q_i) - \sum_{j \neq i} T_{k,j} < 0 \quad (11)$$

I assume buyer i believes it is pivotal if $V_k(Q) - V_k(Q_i) + \sum_{j \neq i} T_{k,j} + u_{i,k} < 0$, where $u_{i,k}$ is normally distributed with mean 0 and variance σ^2 . The magnitude of σ^2 (the parameter to be estimated by the model) indicates the accuracy of the prediction. The probability of buyer i being pivotal is $\Phi\left(\frac{V_k(Q_i) - V_k(Q) - \sum_{j \neq i} T_{k,j}}{\sigma}\right)$ where $\Phi(\cdot)$ is a c.d.f. for a normal distribution with mean zero and variance 1. Buyer i assumes that he is not pivotal for seller k if $V_k(Q) - V_k(Q_i) +$

$\sum_{j \neq i} T_{k,j} + u_{i,k} \geq 0$. Thus, the probability that buyer i is not pivotal is $\Phi\left(\frac{V_k(Q) + \sum_{j \neq i} T_{k,j} - V_k(Q_i)}{\sigma}\right)$.

If the buyer is non-pivotal, the transfer price is determined by (5). However, one might expect the transfer price to differ from this value due to factors not taken into consideration by the model. In particular, one might not expect agents to have the same transfer prices every period. The factors that induce these potential differences are assumed to be the same for both the pivotal and non-pivotal case. If the buyer is non-pivotal, the transfer price is:

$$T_{i,k} = v_{i,k}(1 - \alpha_i) - \alpha_i(V_k - V_{-i,k}) - \varepsilon_{i,k} \quad (12)$$

If the buyer i is pivotal, then the transfer price is equal to the expected value of the transfer price as determined by equation (6), given that the buyer i is pivotal, plus an error term.

$$T_{i,k} = E[v_{i,k}(1 - \alpha_i) - \alpha_i\left(\sum_{j \neq i} T_{j,k} - V_k + u_{i,k}\right) | V_k(Q_{-i}) + \sum_{j \neq i} T_{k,j} + u_{i,k} < 0] + \varepsilon_{i,k} \quad (13)$$

Since there are two error terms, the error term regarding the buyer's being pivotal is restricted. The only condition for the second error term is that $\varepsilon_{i,k}$ is i.i.d. with $E[\varepsilon_n] = 0, \forall n$. When the buyer assumes it is pivotal, the $u_{i,k}$'s tend to be higher, i.e., $E[u_{i,k} | i \text{ is pivotal}] > 0$. Thus, there is a selection bias in transfer prices when the buyer is pivotal. Note that equation (13) simplifies to

$$T_{i,k} = v_{i,k}(1 - \alpha_i) - \alpha_i V_k(Q_i) + \varepsilon_{i,k} - \alpha_i E[(\sum_{j \neq i} T_{j,k} + V_k(Q_{-i}) + u_{i,k}) | u_{i,k} < -V_k(Q_{-i}) - \sum_{j \neq i} T_{k,j}]. \text{ Thus:}$$

$$T_{i,k} = v_{i,k}(1 - \alpha_i) - \alpha_i(\sum_{j \neq i} T_{j,k} + V_k) + \sigma \frac{O(\frac{\sum_{j \neq i} T_{j,k} + V_k(Q_{-i})}{\sigma})}{1 - \Phi(\frac{\sum_{j \neq i} T_{j,k} + V_k(Q_{-i})}{\sigma})} + \varepsilon_{i,k} \quad (14)$$

Note that only the transfer price is seen from the raw data, and it is not known whether the buyer was assumed to be pivotal or non-pivotal during the transfer price determination. Since the probability that a given buyer is pivotal for a given seller is known, I estimate the bargaining power from the following nonlinear model:

$$T_n = g(\bar{d}, \bar{v}, \bar{T}, \bar{\alpha}, \bar{V}, \sigma) + \varepsilon_n \quad (15)$$

or

$$\begin{aligned} T_n = & \sum_{i=5}^9 \sum_{k=1}^4 d_{i,k} (\Phi(\frac{V_k(Q_i) - \sum_{j \neq i} T_{k,j} - V_k(Q_i)}{\sigma})) (v_{i,k}(1 - \alpha_i) \\ & - \alpha_i(V_k - V_{-i,k})) + \Phi(\frac{V_k(Q_i) - V_k(Q_i) - \sum_{j \neq i} T_{k,j}}{\sigma}) (v_{i,k}(1 - \alpha_i) \\ & - \alpha_i(\sum_{j \neq i} T_{j,k} + V_k) + \sigma \frac{O(\frac{\sum_{j \neq i} T_{j,k} + V_k(Q_{-i})}{\sigma})}{1 - \Phi(\frac{\sum_{j \neq i} T_{j,k} + V_k(Q_{-i})}{\sigma})})) + \varepsilon_n \end{aligned}$$

which simplifies to following nonlinear function:

$$\begin{aligned} T_n = & \sum_{i=5}^9 \sum_{k=1}^4 d_{i,k} (v_{i,k}(1 - \alpha_i) - \sigma O(\frac{\sum_{j \neq i} T_{j,k} + V_k(Q_{-i})}{\sigma}) \\ & - \Phi(\frac{-V_k(Q_{-i}) - \sum_{j \neq i} T_{k,j}}{\sigma}) \alpha_i (V_k(Q_{-i}) + \sum_{j \neq i} T_{k,j})) + \varepsilon_n \end{aligned} \quad (16)$$

where T_n is the transfer price from the negotiation between buyer j and seller

l .² Note that d is a dummy variable that is equal to 1 if $i = j$ and $k = l$, and 0

²This formulation allows for an un-balanced model, since we do not require all the buyers to conduct successful trades every period and there is no time dimension included.

otherwise.

I assume that a buyer's bargaining power varies from buyer to buyer, but does not change from seller to seller and from period to period.³ There are $N = 153$ observations, with six parameters to be estimated. The sellers are indexed by 1, 2, 3, 4, while the buyers are indexed by 5, 6, 7, 8, 9. Finally, α_i represents buyer i 's bargaining power.

IV Estimation Results

I begin by estimating the restricted model that assumes bargaining power is *constant across firm size*. These results are presented in Table 1. Clearly, the estimates of both bargaining power and sigma are significant. Note that bargaining power is estimated to be 0.6794. Thus, even without estimating the unrestricted model it is clear that the hypothesis that bargaining power is 0.50 is rejected at the 99% confidence level.

Next, I estimate the unrestricted model where bargaining power is allowed to vary across buyers. The nonlinear least squares estimation results are presented in Table 2. As can be seen from the table, all parameter estimates are significant. Notice that for buyer 9, bargaining power is 0.2985, while it is between 0.64 and 0.75 for all other buyers. Note that the adjusted R-Squared has increased from 0.8363 to 0.9210, which suggests that the efficiency gains from unrestricted model are high. Finally, I test the restricted model versus the unrestricted model. Specifically:

³This is a standard assumption in the models discussed in the introduction.

H_0 : Restricted Model (bargaining power is constant across buyers)

H_A : Unrestricted Model (bargaining power is asymmetric).

Under H_0 , $t = \frac{(e^*e^* - e'e)/5}{e'e/(153-6)} \sim F(5, 153-6)$.⁴, where e^*e^* is the residual from restricted model and $e'e$ is the residual from unrestricted model. This calculation gives $t = 44.638$ and the restricted model is rejected at the 99% confidence level.⁵

V Discussion

The question of symmetry of bargaining power is important in evaluating a mergers effect on a merged firm's bargaining position. If bargaining power is constant across firms and there is no pivotal mechanism (the Chitty and Snyder case), the merged firm's bargaining position will be solely determined by the shape of the value function. Moreover, when we include the pivotal mechanism, becoming big negatively affects the merged firm's bargaining position (the Raskovich case). However, these results hold only for the case of constant bargaining power across firms. When bargaining power increases with firm size, becoming pivotal can allow the merged firm to improve its bargaining position. This improvement in bargaining position tends to increase the transfer prices from smaller pivotal buyers to sellers. Adilov and Alexander (2002) suggest several reasons why the merging firm's bargaining position might increase. These

⁴See Greene, page 344

⁵F(5,147) for the 99% confidence level is 3.02. One can also test whether all bargaining power coefficients are jointly equal to the value from the restricted model. The test statistic t should be distributed as $F(5, 147)$. This calculation gives $t = 44.61$ and, once more, the hypothesis is rejected at the 99% confidence level.

reasons include (but are not restricted to) informational benefits, retention of higher quality bargaining skills, a lower risk aversion coefficient, and a lower discounting factor for the merged firm.

Nonlinear least squares estimates of bargaining power based on the experimental data from the Bykowski et al. (2002) experiments, suggests that bargaining power differs considerably among buyers even in the absence of capacity constraints or MFN clauses. Bykowski et al. estimate that MFN clauses increase buyer's bargaining power significantly; however, there is a significant gap in the economic literature concerning the emergence of MFN clauses in the cable industry. It appears that zero marginal distribution costs and non-rivalrous provision of television programming creates a unique and contradictory environment for implementing MFN clauses. Furthermore, there is uncertainty about the payments from the cable operator to program provider since the payment includes a fixed transfer and advertising time. Advertising revenue makes cable operators' revenue fluctuate considerably depending on program quality and audience sizes. All these suggest that MFN clauses and the shape of their value function are not the only factors that explain the lower transfer payments from larger buyers.

The estimation results suggest that bargaining power is not symmetric across firms, even in controlled experimental environments without MFN clauses or channel capacity constraints. It follows that there *is* no reason to expect that bargaining power is constant in more complex environments.

References

- [1]**Nodir Adilov and Peter J. Alexander.** Federal Communications Commission. Media Bureau Staff Research Paper No. 13. "*Asymmetric Bargaining Power and Pivotal Buyers.*" (rel. October 9, 2002).
- [2]**Nodir Adilov and Peter J. Alexander.** Federal Communications Commission. Media Bureau Staff Research Paper No. 14. "*Most-Favored Customers In the Cable Industry.*" (rel. October 9, 2002).
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- [4]**Tasneem Chitty and Christopher M. Snyder.** "*The Role of Firm Size in Bilateral Bargaining: A Study of Cable Television Industry.*" Review of Economics and Statistics 81(2)(1999). 326-40.
- [5]**William H. Greene.** "*Econometric Analysis.*" 3rd ed. (Upper Saddle River, NJ: Prentice-Hall, Inc. 1997). 333-374.
- [6]**Alexander Raskovich.** US Department of Justice. Economic Analysis Group Discussion Paper 00-9. "*Pivotal Buyers and Bargaining Position*", (as of October 22, 2001).

Table 1: Restricted Nonlinear LS: Constant Bargaining Power

	Number of Obs	=	153
	$F(2, 151)$	=	319.48
	Prob > F	=	.0000
	R-Squared	=	.8089
	Adj R-Squared	=	.8063
	Root MSE	=	100.682
	Res. dev.	=	1843.444

T_n	Coef	Std. Er	t	$P > t $
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α	.6793967	.0128873	52.72	.000
Sigma	113.7688	34.94846	3.26	.001

Table 2: Unrestricted Nonlinear LS: Asymmetric Bargaining Power.

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	Number of Obs	=	153	
	$F(6, 147)$	=	298.28	
	$Prob > F$	=	.0000	
	R-Squared	=	.9241	
	Adj R-Squared	=	.9210	
	Root MSE	=	64.3026	
	Res. dev.	=	1702.136	
<hr/>				
T_n	Coef	Std. Er	t_z	$P > t $
<hr/>				
α_5	.7042558	.0144198	43.84	.000
α_6	.6484863	.0260494	24.89	.000
α_7	.7206213	.0232192	31.04	.000
α_8	.7434435	.0135440	54.89	.000
α_9	.2985069	.0274519	10.89	.000
Sigma	102.4373	22.03877	1.65	.001
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